First Trust

Fixed Income Newsletter
4th Quarter 2022

William Housey, CFA
Managing Director of Fixed-Income, Senior Portfolio Manager

Bill is a Managing Director of Fixed-Income and is also a member of the First Trust Strategic Model Investment Committee and the Fixed-Income Sub-Committee. Bill joined First Trust Advisors L.P. in June 2010 as the Senior Portfolio Manager for the Leveraged Finance Investment Team. Bill has 25 years of investment experience and has extensive experience in the portfolio management of both leveraged and unleveraged credit products, including senior loans, high-yield bonds, credit derivatives (CDS/LCDS) and work-outs/corporate restructurings.

FIXED INCOME MARKET REVIEW

In the third quarter, inflation remained stubbornly elevated with the August (reported in September) Consumer Price Index printing +8.3% and the Federal Reserve ("Fed") continued to reiterate its commitment to bringing inflation back to its 2% target. The Federal Funds rate increased by 75 basis points (bps) in each of the last three meetings, moving the upper bound to 3.25% and bringing the total to 300 bps of increases over the course of 5 meetings. While there has been much debate within financial markets regarding how far the Fed may be willing to go in terms of overall interest rate policy, in late August at Jackson Hole, we believe Chair Powell made the position of the Federal Open Market Committee on rates and inflation abundantly clear. He said their "overarching focus" is to bring inflation back down to the 2% goal and "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses." In addition, Chair Powell went on to say, "Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy."

Due to the persistence of the inflation data, we do not believe the Fed can "pivot" to a more accommodative posture until either inflation has been tamed or a recession is near or underway, notwithstanding a major financial market calamity. To be clear, we do not think inflation at or near 8%, 7%, 6%, 5%, or even 4% is enough to remove the restrictive policy posture of the Fed. Eventually, either when a recession is imminent or we've entered one, only then do we believe the Fed will begin to ease its restrictive policy.

FIXED INCOME OUTLOOK

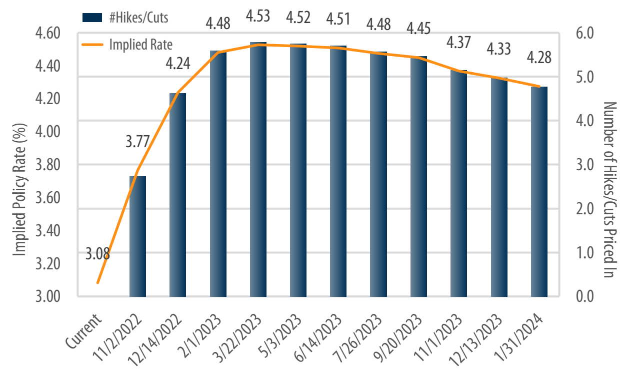
In summary, despite market narratives to the contrary, we believe this Fed remains focused on raising Fed Funds terminal rate to 4.5%-5%, consistent with current market pricing of a terminal rate near 4.5% (see Chart 1). Higher rates will result in demand destruction, and this lower demand should eventually result in lower prices. Ultimately, this lower demand will allow supply chains to rebuild, soften demand for commodities, allow for labor pressures to ease and ease housing prices (which typically lead rents). However, the Fed's policy tools operate with a lag. Therefore, we haven't yet observed the ultimate impact from these recent hikes (or future hikes that we're anticipating) on the overall economy.

Our market framework centers on our view that the Fed will stay the course, increasing interest rates and ultimately holding rates at a restrictive level such that the economy tilts into recession. Given that the Fed's dual mandate centers on inflation and employment, both of which are typically lagging indicators with respect to overall economic activity, we believe the risk of a policy error by the Fed is very high and as such believe recession risk has escalated significantly for 2023. While there is much anecdotal evidence suggesting a slowing U.S. economy, one of the most important indicators is the inverted 2/10 U.S. Treasury yield curve, which has a strong track record of inverting prior to recessions (see Chart 2 and Chart 3).

The Bear Market for risk assets continues, with the fourth such bear market rally having just concluded in August. We believe there will continue to be tactical opportunities for investors to de-risk into bear market rallies. Moreover, we are finding attractive values in nearly all segments of the bond market given the negative returns that have battered the market this year.

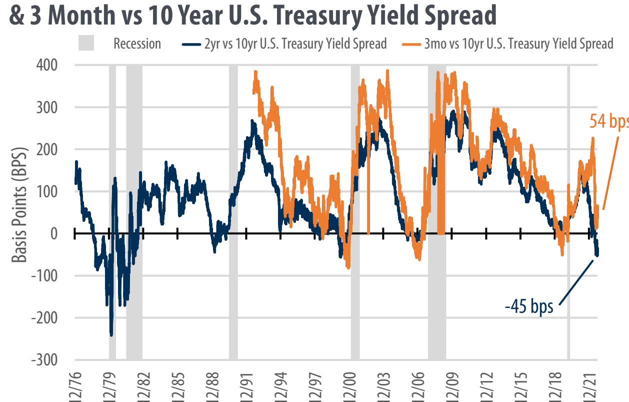
We believe the most important focus for bond investors today is to avoid fighting the Fed. As the Fed continues to bring interest rates higher, we continue to favor duration profiles short of the benchmark, but in acknowledgement of the significant move higher in rates this year, believe duration extension is warranted. Moreover, given the potential for a short business cycle and recession in 2023, we believe favoring higher credit quality is prudent. Given our view of a shorter business cycle (a recession in 2023), we believe that the time, while not quite here yet, is nearing to move durations back to neutral and potentially even extend beyond the benchmark.

Chart 1: Implied Federal Funds Rate & Number of Hikes/Cuts



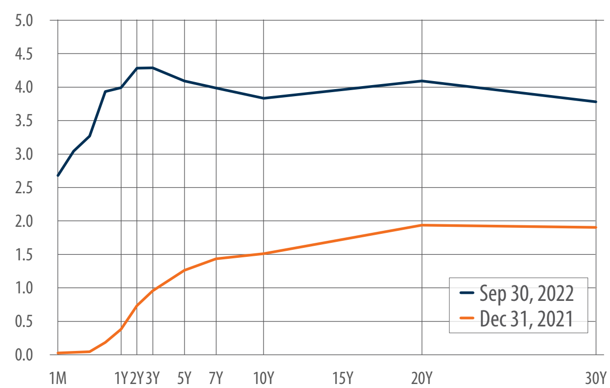
Source: Bloomberg, as of 9/30/2022

Chart 2: 2 Year vs 10 Year U.S. Treasury Yield Spread & 3 Month vs 10 Year U.S. Treasury Yield Spread



Source: Bloomberg, as of 9/30/2022

Chart 3: U.S. Treasury Yield Curve



Source: Bloomberg

There can be no assurance that any of the trends and projections cited herein will continue or come to fruition.

SECTOR POSITIONING

Ultra-Short Maturity

We expect short term interest rates to rise, reflecting the rapid acceleration of the Fed's tightening cycle. We anticipate that ultra-short duration securities will produce higher income as interest rates increase while exhibiting lower volatility than other fixed income sectors.

Mortgage-Backed Securities

Mortgage rates have risen rapidly, driving down refinancing activity which greatly extended durations. While housing is beginning to slow with headwinds primarily focused on affordability driven by supply and demand imbalances, Fed Chair Powell emphasized that they are not considering Mortgage-Backed Securities (MBS) sales over the near term, providing relief to agency MBS and valuations are at levels last experienced during the pandemic. We continue to favor defensive MBS structures and given the extension that has already occurred, increased recession risk and lower risk of Quantitative Tightening MBS sales over the near term, have a more favorable view of higher quality agency backed securities.

Treasury Inflation Protected Securities (TIPS)

We expect inflation will remain persistently higher than the Fed's 2% target, however, the Fed's more restrictive policies have resulted in inflation breakevens (market expectations for inflation) pricing a rapid reversion in inflation. Higher real interest rates have been a headwind to TIPS. While breakevens may have modest upward pressure in the medium term, inflation has historically declined in or around recessions. Our expectation is for inflation to follow this historical pattern given we expect the economy to slow and recession risk to be high in 2023. As such, we have not added to TIPS in our models.

U.S. Treasury Securities

The Fed raised short term interest rates 75 basis points in the last three meetings and have signaled an aggressive policy path into next year. In the near term, we believe this is likely to keep interest rate volatility high within the bond market but over time, we believe higher rates are likely to curtail economic activity. Therefore, we expect further yield curve flattening/inversion over the coming quarters and in time, believe U.S. Treasuries will again be a safe haven asset relative to credit risk.

High-Yield Bonds

High-yield bonds generated attractive relative returns after prices had previously fallen to approximately 87 cents on the dollar and a 600 OAS (option-adjusted spread) at the end of the second quarter. Higher yields should mitigate some total return downside offsetting spread widening that may come with increasing recession risk. While high-yield spreads over U.S. Treasuries are near the long-term average and defaults are projected to remain low over the near term, we believe recession risk is rising in 2023 and therefore we expect earnings volatility, especially in cyclical and consumer-sensitive segments of the market moving forward. We favor increasing credit quality and owning sectors with acyclical earnings because we expect more favorable opportunities to increase the allocation to high-yield bonds at more attractive valuation levels.

Senior Loans

Senior loan prices have outperformed many fixed income asset classes given their floating rate coupon and ultra-short duration profile. While loans spreads over the Secured Overnight Financing Rate (SOFR) and London Interbank Offered Rate (LIBOR) are near the long-term average and defaults are projected to remain low over the near term, we believe recession risk is rising in 2023 and therefore we expect earnings volatility, especially in cyclical segments of the market moving forward. Given our view that restrictive financial conditions are significantly increasing recession risk, we favor increasing credit quality and defensive positioning in sectors with acyclical earnings at this stage in the cycle. We will opportunistically look for attractive entry points to increase the allocation to senior loans at more attractive valuation levels.

Investment Grade Corporate Bonds

We believe corporate balance sheets are in a strong position outside of cyclical and consumer-oriented sectors. However, we believe forward-looking earnings growth expectations should fall further as companies face pressure from a strong U.S. dollar, slower economic growth and a weakening consumer. Spreads and nominal yields are attractive compared to the last 10 years but the bias in spreads is wider as we believe we are moving closer to a recession. Volatility and fund outflows remain a headwind but also provide opportunities for active managers. We favor defensive sector positioning and are more constructive on the front end of the yield curve where yield is well in excess of duration, although we see opportunities developing along the curve as bond prices fall to reflect higher rates.

Preferred Securities

We view preferred securities market valuations to be more attractive and may offer appreciation potential as they are pricing in significant headwinds. Prices, measured by percent of par are trading close to 90%, which is the lowest since the onset of the pandemic. We believe that variable rate securities, which are trading at a discount to par, have the greatest potential for appreciation as they are near their call dates and have the potential to pull back to par. The majority of issuers in the preferred securities market are solid investment grade credits, with an average senior issuer rating of low single A. We expect the largest sector, banks, to outperform the broad credit markets in the upcoming economic slowdown due to solid capital and reserve levels and the major tailwind of rising interest rates lifting net interest income revenues. Despite these improved valuations, given our expectation for continued volatility, we have not increased our preferred securities allocation and will continue to evaluate the sector for potential opportunistic entry points.

Emerging Market Bonds

Aggressive Fed action and a strong U.S. dollar have been headwinds to Emerging Market valuations while fundamentals are showing more signs of stress. Providing modest support for Emerging Market currencies is the fact that Emerging Market policy rates have moved higher generally, with 17 of 20 Emerging Market central banks raising interest rates. China's monetary easing and credit growth are providing some offset to rolling domestic Covid lockdowns, but the outlook is strained. Local yields remain attractive on a historical basis, however fund outflows so far this year are the highest since 2018 and we believe the environment for Emerging Market debt remains challenging.

Municipal Fixed Income

Higher interest rates have not spared the municipal market this year. Fund flows have been significantly negative this year and we believe that along with U.S. Treasury moves, will be the most important technical factors driving performance in the fourth quarter. Credit fundamentals are stable or improving for most sectors given significantly higher revenues and fiscal stimulus programs, credit rating upgrades remain positive and default rates year-to-date are lower than 2021, though economic headwinds would be expected to ultimately flow down to the sector. We are more constructive on the front end of the yield curve where yield is well in excess of duration, although we see opportunities developing along the curve as bond prices fall to reflect higher interest rates.